Features

Macro-Prudential Supervision in Europe and the U.S.: An Institutional Perspective

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Introduction

This article delves into a comparative analysis of the European Systemic Risk Board (ESRB) and the Financial Stability Oversight Council (FSOC), with a focus on their roles in promoting financial stability and mitigating systemic risk. Both entities were established in response to the 2009 Global Financial Crisis (GFC), but they differ in their approaches and regulatory powers. The ESRB, part of the European System of Financial Supervision (ESFS), primarily relies on advisory powers, including those of issuing warnings, recommendations and employing a "comply or explain" mechanism. In contrast, the FSOC initially had more robust regulatory powers, allowing it to designate non-bank financial companies as Systemically Important Financial Institutions (SIFIs).

The article argues that the FSOC's ability to promote financial stability was eroded by political influence, particularly through the 2019 revised interpretative guidance. The ESRB was also reformed in 2019 via amendments to the ESRB Regulation, however the amendments were minor and did not impact the body’s effectiveness. The analysis is structured around three key areas: mandate and empowerment, governance and accountability, and data collection and aggregation. It examines the changes each institution underwent post-amendments and their possible impact on the effectiveness of the institutions.

The points in this article are derived from and attempt to summarise a paper on this subject co-authored with Matthew Xerri, Margaux Morganti and Beatriz Brunelli Zimmermann.

Background

The 2009 GFC revealed significant flaws in the United States' economic model and prompted a major overhaul of its financial regulatory system. The crisis resulted from various complex factors and regulatory failures, with excessive liquidity and low interest rates serving as underlying causes. The proliferation of financial innovation exacerbated the consequences of these issues, and the crisis quickly became systemic due to financial interconnectedness. Fundamental failures in risk assessment by financial entities and regulators also became apparent.

The crisis' impact soon reached a global scale, with a vicious circle of sovereign and bank risk becoming evident, particularly in the European Union (EU), where high sovereign debt levels were fuelled by public deficits. In response, the European Commission formed a High-Level Group on Supervision, led by Jacques de Larosière. The group recommended enhanced cross-border coordination among national authorities and the creation of a Union-level body for macro-prudential supervision with an aim to oversee and mitigate systemic risk, leading to the establishment of the ESRB.

On the other side of the Atlantic, the Financial Crisis Inquiry Commission highlighted the lack of oversight that was needed to safeguard financial stability. This eventually led to the adoption of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) in 2010. This legislation established, inter alia, the FSOC to improve coordination among US regulators and provide a comprehensive view of systemic risks.

Comparative Analysis Between the ESRB and the FSOC

I. Mandate and Empowerment

The FSOC and the ESRB have distinct mandates and approaches stemming from the different experiences in America and Europe during the 2009 GFC. The FSOC aims to identify risks to financial stability in the US, emphasising the significance and risk of Too Big to Fail (TBTF) entities, whether they are banks or nonbank financial companies (NFCs). Its role includes promoting market discipline and responding to emerging threats. The ESRB, on the other hand, focuses on potential risks arising from developments within the European financial system and macroeconomic factors. The ESRB employs a soft law approach, issuing warnings and recommendations, and its authority does not include hard regulatory or supervisory powers.

While the FSOC has more regulatory powers, particularly in designating NFCs as Systemically Important Financial Institutions (SIFIs), which would be subject to harsher prudential requirements, it does not directly supervise these institutions, delegating that responsibility to the Federal Reserve System. The ESRB, on the other hand, relies on cooperation with National Competent Authorities (NCAs) and sectoral European Supervisory Authorities (ESAs) for supervision. Overall, the FSOC has regulatory, but not supervisory, powers, while the ESRB possesses soft law-based regulatory and supervisory authority through its mechanisms of persuasion and cooperation.

II. Governance and Accountability

The FSOC and the ESRB also have different governance structures. The FSOC has 10 voting members representing federal authorities, including the secretary of the Treasury, the chairman of the Federal Reserve System, and heads of various regulatory bodies. It also has five non-voting members who serve in advisory roles. The voting members make most decisions by a simple majority, except when designating an entity as a SIFI, where a two-thirds majority is required. Accountability is maintained through annual reports and congressional testimony.

In contrast, the ESRB's General Board includes members such as the president and vice president of the European Central Bank, the governors of national central banks, and the chairs of the ESAs. Generally, it employs a majority voting mechanism, however decisions for making a recommendation or to make warnings or recommendations public require a two-thirds majority. Accountability is upheld through mandatory annual reports to the European Parliament and the European Commission. Challenges for the ESRB include the close relationship with the ECB and potential delays in decision-making due to its extensive list of voting members. In comparison, the FSOC's smaller size may suggest faster decision-making, but conflicts of interest and regulatory fragmentation have sometimes led to paralysis.

III. Data collection and Aggregation

In the aftermath of the 2009 GFC, the importance of cross-border data collection and aggregation to identify and mitigate systemic risks became evident. The FSOC has a key role in gathering data from regulatory and supervisory authorities, and it can direct the Office of Financial Research (OFR) to collect information from financial institutions. The OFR also has subpoena power. In contrast, the ESRB collects data from various EU and national entities, which is maintained in aggregate and summary form to avoid identifying specific institutions. Challenges in data collection include data quality, timeliness and stakeholder cooperation. The FSOC's direct relationship with the OFR simplifies data collection compared to the ESRB, which relies on multiple stakeholders and mechanisms, potentially impacting data timeliness and quality.

Latest Changes in Legislation

Both the FSOC and the ESRB have undergone amendments to their founding regulations. In the case of FSOC, it revised its interpretative guidance in 2019 to move from an entities-based approach to an activities-based one and introduced a cost-benefit analysis for designating SIFIs This was in response to concerns and legal challenges to previous SIFI designations, such as those of MetLife and General Electric Capital Corporation. In contrast, the ESRB made minimal changes to its regulation in 2019, enhancing its data collection capabilities and extending its coordination role for macroprudential policies at the national level. These changes aimed at improving the ESRB's effectiveness in mitigating systemic risks in the EU.

Discussion

The article compares the ESRB and the FSOC in three key areas: mandate and empowerment, governance and accountability, and data collection and aggregation. However, the discussion focuses on how the legislative amendments have altered the areas of mandate and empowerment.

Before the amendments, the FSOC had a more regulatory role with the power to designate NFCs as SIFIs; whereas the ESRB operated in an advisory capacity with limited enforcement abilities. However, neither body had direct supervisory authority over firms.

In terms of post-amendments changes, while the amendments to the ESRB have been minor, the changes to the FSOC via the 2019 revised interpretative guidance have been major. These significant changes related to the designation process of SIFIs, which have not de jure erased the Council's power to designate NFCs as SIFIs, but it has de facto placed major constraints to the designation process via the activity-based approach and the cost-benefit analysis. The changes made to the FSOC are highly political in nature and reflect changes of presidential administrations. This shows that the FSOC may be vulnerable to political cycles.

Overall, the changes to the FSOC have significantly altered its operations, potentially making it more susceptible to political influence, while the ESRB has retained its advisory role with minor improvements to its data collection capabilities. The FSOC's shift toward an activity-based approach has raised concerns about its effectiveness in preventing systemic risks and fulfilling its mandate.

Conclusion

This article compares the FSOC and the ESRB in terms of mandate, governance and data collection, both before and after amendments. It highlights that the FSOC, which had more regulatory powers, has undergone significant changes due to the 2019 revised interpretative guidance, leading to its potential vulnerability to political influence. On the other hand, the ESRB, despite limitations, may now be better equipped to prevent systemic risks and ensure financial stability. The article suggests that the FSOC's governance arrangements need to be redesigned to reduce political influence and that future research should focus on further projected legislative changes for both bodies.

Disclaimer:

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